82-469

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No.

In The Supreme Court

Of The

United States

OCTOBER TERM, 1982

ESTATE OF ERNEST D. SKAGGS, DECEASED,
CAROLYN C. FIKE, EXECUTRIX, AND
CAROLYN C. FIKE, FORMERLY CAROLYN C. SKAGGS
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For
A Writ of Certiorari To The
United States Court Of Appeals For
The Ninth Circuit

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QUESTION PRESENTED FOR REVIEW

Whether a partnership, composed solely of a husband and wife who held their partnership interests as community property, is for federal income tax purposes deemed to exist upon the death of one spouse.

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OPINIONS BELOW

The Opinion of the Court of Appeals is reproduced in the Appendix, page A-1. The Order Amending Opinion And Denying Rehearing is reproduced in the Appendix, page A-5. The opinion of the United States Tax Court is reported at 75 T.C. 191 (1980) and is reproduced in the Appendix, page A-7.

JURISDICTION

The Opinion of the Court of Appeals was filed on March 24, 1982. The Order Amending Opinion And Denying Rehearing of the Court of Appeals in response to Petitioners' Petition for Rehearing, was filed on May 27, 1982. The jurisdiction of this court is invoked under 28 U.S.C. §1254(1).

STATUTES AND REGULATIONS INVOLVED

The full text of the statutes and the pertinent provisions of the regulations involved in this case, identified by the following citations, are set forth in the Appendix, at page A-33, et seq.:

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 708

Sec. 754

Sec. 743

Treasury Regulations on Income Taxes (26 C.F.R.)

Sec. 1.708-1(a) to 1.708-1(b) (1) (i) (a)

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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STATEMENT OF THE CASE

Ernest D. Skaggs ("Ernest") and Carolyn C. Skaggs (now Carolyn C. Fike, hereafter "Carolyn") were husband and wife. They were domiciled in California and operated a farm (the "Santa Rita Ranch") near Los Banos, California. California

community property law as it then existed gave sole management and control of community property to the husband (Cal. Civil Code §5125, repealed January 1, 1975). Desiring to give Carolyn equal participation in the management and control of Santa Rita Ranch, the spouses on April 22, 1967 executed a written partnership agreement which made Carolyn and Ernest sole and equal partners in Santa Rita Ranch. Ernest died on December 31, 1973, leaving Carolyn, his widow, as sole remaining partner. Ernest's Will named Carolyn as sole beneficiary and nominated her as Executrix.

When Ernest's Will was admitted to probate, Carolyn was appointed and qualified as Executrix. Under the law of California in effect at that time, all of the community property owned by a husband and his widow at the date of the husband's death became subject to probate administration.

Article 8 of the Santa Rita Ranch partnership agreement provided that "the partnership shall terminate upon the death of either partner". On February 28, 1974, Carolyn as Executrix filed with the Probate Court a petition verified by her oath which set forth that the Santa Rita Ranch partnership terminated upon Ernest's death and that, as a result of such termination, the assets of the farming business theretofore conducted by the partnership became subject to the jurisdiction of the Probate Court.

On March 15, 1974, the Probate Court made its "Order Authorizing Executrix to Continue Operation of Farming Business". The Order found that the partnership terminated upon Ernest's death and that all of the partnership assets became subject to the jurisdiction of the Court. Said Order

authorized Carolyn as Executrix to continue the operation of Santa Rita Ranch under the same name as had been used by the partnership.

For the calendar year 1974, Carolyn C. Skaggs filed two federal income tax returns. One was a fiduciary return (Form 1041) for the Estate of Ernest D. Skaggs. The other was an individual tax return (Form 1040) for herself. Each item of 1974 income and expense from Santa Rita Ranch was apportioned in said returns one-half to the Estate and one-half to Carolyn. In both the fiduciary and the individual returns, Carolyn claimed as a deduction for "basis in growing crops", the amount of $207,968, or one-half the fair market value of unharvested crops on hand as of the date of Ernest's death. Similar recomputations were made of the basis of the other assets of Santa Rita Ranch, on the theory that under Section 1014 of the *Internal Revenue Code* (the "Code") it was proper to "step up" the basis of each such asset to its value at the date of Ernest's death.

Ernest had died on the last day of the partnership's 1973 taxable year. The partnership filed a 1973 tax return but filed no subsequent returns. It made no election pursuant to *Code Section* 754.

The Commissioner of Internal Revenue determined that the partnership continued in existence following Ernest's death and therefore, because no such election was filed by the partnership, the new date-of-death basis under Section 1014 applied only to the partners' partnership interests in Santa Rita Ranch and not to the assets held by Santa Rita Ranch. He therefore disallowed the basis "step up" and imposed tax assessments totalling $252,344.00 on Carolyn and the Estate.

This case was originally tried in the United States Tax Court. Jurisdiction before the Tax Court was established under *Code Sections* 7442 and 6213(a).

The case was submitted for decision to the Tax Court on a detailed and comprehensive stipulation of facts. It is devoid of anything explicity acknowledging the existence of a partnership. For example, the documents filed in the probate proceedings and made a part of the Tax Court record contain nothing stating that Carolyn, as Executrix, took into her possession a partnership interest, had receipts from or made disbursements to any partnership, or sought an authorization to join with any other partner in the operation of Santa Rita Ranch. Even the form of the statutory notices of deficiency issued by the Commissioner of Internal Revenue are consistent with the termination of the partnership as of the date of Ernest's death. The notices adjust the basis of the "partners" under *Code Section* 1014 rather than adjusting taxable income from the partnership. An adjustment to the basis of partnership assets (not individual assets), thereby increasing partnership taxable income, would have been the only appropriate adjustment under the Commissioner's theory.

The Tax Court nevertheless sustained the position of the Commissioner.

The United States Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

A. The Nature of the Reasons.

This is a case of first impression. Research has disclosed no case involving either tax law or local partnership law that comes close to presenting the specific factual and legal relationships that are involved in this case.

The holdings of the Court of Appeals and the Tax Court impose a tax result which contravenes the property rights and interests of Carolyn, both as Executrix and individually, under California partnership, probate and community property laws. For this reason, the decision of the Ninth Circuit conflicts with decisions of this Court with regard to the significance of state law in determining the property rights of taxpayers. The decision affects not only the rights of taxpayers in the State of California, but also the rights of taxpayers in other community property states. It creates a serious and unnecessary trap for taxpayers in such states. The issue presented therefore constitutes an important question of federal tax law, which has not been, but should be, addressed by this Court.

B. The Partnership Ceased to Exist Following the Death of Ernest.

Section 15006 of the *California Corporations Code* defines a partnership as follows:

> "A partnership is an association of two or more persons to carry on as co-owners a business for profit."

The two essential elements of a partnership, then, are the existence of two or more persons and an agreement to act

together in such a way as to become a partnership.

By the terms of the Santa Rita Ranch partnership agreement and the orders of the California Probate Court, the partnership ceased to exist upon Ernest's death and all interest in all of the assets in Santa Rita Ranch merged into Carolyn as Executrix. After the merger, there was no longer an "association" of two or more persons in existence who held an interest in Santa Rita Ranch to act as a partnership after Ernest's death. The conclusion of the Tax Court that the partnership continued after Ernest's death is therefore contrary to California law.

The Tax Court based its holding that the partnership continued to exist on *Treasury Regulation* Section 1.708-1 (b). This Regulation provides that the death of a partner does not terminate a partnership if the estate of the deceased partner continues to share in the profits and losses of the business. This rule makes sense in a non-community property state. In a common law jurisdiction, the decedent's estate is simply "slipped into the shoes" of the decedent's and the business is continued in partnership with some other party. By creating a continuity for tax purposes, the Regulation prevents an artificial termination of the partnership with the simultaneous commencement of what is essentially the same partnership with the estate of the decedent in place of the decedent.

But the Tax Court's application of the cited Regulation to the facts of the case at bar is inappropriate because only one person - Carolyn, as Executrix - existed who had the legal right to the possession and use of the partnership assets under California partnership, probate and community property laws.

Under the California probate law in effect at Ernest's death, the probate of his estate was an action *in rem* binding on all creditors and claimants, including his widow, under the plenary supervision and control of his legal representative and the Probate Court. *Colden v. Costello*, 50 Cal. App. 2d 363, 370, 122 P. 959 (1942). As Executrix, Carolyn had complete power to carry on the farming business operations. Carolyn's sole right and power, as Executrix, over the assets of the business negates the possibility of the existence of two persons to consent to the formation or continuation of a partnership for tax purposes. The decision of the Tax Court thus fails to recognize the rights and interests of Carolyn, as Executrix, as established under the probate laws of the State of California.

The Tax Court reasoned, however, that because there were two *taxpayers*, Carolyn individually and Carolyn as Executrix, to report the income from the business, there were two *persons* in existence to continue the partnership. The income taxation of the income of Ernest's estate would have been the same if Ernest had operated the farming business as a sole proprietorship composed of community property and his estate had succeeded to it: the two taxpayers are recognized regardless of the existence of a partnership. Their recognition as such therefore cannot be evidence of the existence of a partnership. The fact that two taxpayers were required by the federal tax laws to report the income from the business does not necessitate the conclusion that said two taxpayers each had ownership interests in the assets of the business sufficient to enable them to constitute a partnership.

The Tax Court further reasoned that although the partnership dissolved on Ernest's demise, it did not terminate

until its affairs had been wound up. In so holding, the Tax Court confused the notion of winding up a *business* with the concept of winding up a *partnership*. The Tax Court determined that because the business was not wound up and terminated until several months following the date of death of Ernest the partnership necessarily was not wound up and terminated until that time. The Court failed to recognize that, under California law, a partnership may distribute its assets at any time, regardless of the condition of its business. The fact that the partnership terminated and all of the assets of the partnership were distributed to Carolyn, as Executrix, as of the date of death for purposes of State law is amply evidenced by the holding of the Probate Court.

Code Section 708 states that a partnership shall be considered as terminated if no part of any business continues to be carried on by any of its partners *in a partnership*. Clearly, if the partnership distributes out all of its assets it has terminated. The fact that Carolyn, as Executrix, continued to hold the assets and wind down the business does not mean that a partnership continued to exist.

C. The Decisions of the Tax Court and the Court of Appeal are in Conflict with Decisions of this Court.

This Court in *Morgan v. Commissioner*, 309 U.S. 78, 60 S. Ct. 424 (1940), laid down the rule that State law establishes the right of taxpayers and federal tax rules designate how those taxpayers shall be taxed given the nature of those rights.

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Id. at 80, 60 S. Ct. at 426.

See also, Treasury Regulation 301.7701-1(c).

Under California State law, only one person - Carolyn, as Executrix - held all of the rights, interest and powers in the assets of Santa Rita Ranch and the partnership ceased to exist as of Ernest's death. Under *Code Section* 754, only a partnership may make the Section 754 election. Under California probate, partnership and community property laws, no partnership existed after Ernest's death. Thus, no Section 754 election was possible or required.

D. The Issue Presented Constitues an Important Question of Federal Tax Law Which Has Not Been, But Should Be, Addressed by This Court.

Under the community property laws of the State of California prior to 1975, Carolyn had no right to manage Santa Rita Ranch. Therefore, she and Ernest executed a partnership agreement giving her that power. The law was later changed and now both spouses have equal right to manage the community property. *Cal. Civil Code Sec.* 5125. Equal right of management now prevails in most community property states. *Ariz. Rev. Stat.* §25-214, *Idaho Code* §32-912, *Nev. Rev. Stat.* §123.230, *N.M. Stat. Ann.* §57-4A-8, *Tex. Fam. Code Ann.*§5.22 (Vernon) and *Wash. Rev. Code Ann.*§26.16.030. Consequently the adverse effect of the decisions of the Tax Court and Court of Appeals will impact on every husband and wife business not only in the State of California, but in every other community property state.

The holdings of the Tax Court and the Court of Appeals, by confusing the rights and interests of the two spouses in their community property, create a serious and unnecessary trap for taxpayers in community property states. The Court of Appeals, in its Order Amending Opinion and Denying Rehearing, stated that its review was limited to facts where a husband and wife executed a formal partnership agreement and does not deal with, nor apply to, an "ordinary community property situation...." Yet the facts involved are indistinguishable from an ordinary community property situation. Community property ownership of a business engenders both spouses with an equal right to possession and management. The management of a community property business by spouses is, because of the nature of community property, essentially a partnership.

As indicated above, federal tax laws determine whether a partnership exists for tax purposes once the rights and relationships of the taxpayers have been determined by local law. Because every community property proprietorship business is essentially a partnership, the Commissioner of Internal Revenue could in each case require every surviving spouse of a community property business to file a partnership return containing an election under *Code Section* 754 in order to obtain a stepped up basis for the business assets where the spouses never contemplated a partnership business or filed a partnership return prior to the date of death of the deceased spouse.

The distinction which the Court of Appeals makes between the existence and nonexistence of a written partnership agreement creates a distinction between the business operations of various groups of spouses where no difference in

rights and powers exists. The decision adversely affects every husband and wife business operated in a community property state. All such taxpayers run the risk of losing a stepped up basis on the death of either spouse. The footnote added by the Court of Appeals does not address or provide an answer to the serious risks which arise in the "ordinary community property situation" under this decision. The addition of the footnote merely highlights the existence of the problem rather than resolving it. If the problem did not exist, why did the Court of Appeals add the footnote?

The decision below thus imposes a tax result upon the taxpayers which is in conflict with the rights of the taxpayers as established under the partnership, probate and community property laws of the State of California and which generates an arbitrary distinction between various groups of taxpayers. The decision will have an adverse effect on taxpayers of all community property states and is contrary to previous decisions of this Court with respect to the significance of local law in determining the property rights and relationships of taxpayers for tax purposes.

CONCLUSION

For the foregoing reasons, the Petition for Certiorari should be granted.

Respectfully submitted,

THOMAS, SNELL, JAMISON, RUSSELL, WILLIAMSON & ASPERGER

By William N. Snell

William N. Snell

APPENDIX "A"

CERTIFIED FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ESTATE OF ERNEST D. SKAGGS, Deceased,
CAROLYN C. FIKE, EXECUTRIX, AND
CAROLYN C. FIKE, FORMERLY
CAROLYN C. SKAGGS,

Plaintiffs and Respondents,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

CA NO. 81-7058
TAX No. 6546-78

OPINION

COURT OF APPEALS
FOR THE NINTH CIRCUIT

FILED
MAR 24, 1982
PHILLIP B. WINBERRY, Clerk

By _____
Deputy

APPEAL from the Decision of the United States Tax Court
Argued and submitted February 9, 1982

Before: FARRIS, FERGUSON and NELSON, Circuit Judges

PER CURIAM:

Petitioners appeal the Tax Court's decision that absent a timely election under *I.R.C.* § 754, the bases of the partnership assets could not be adjusted on the death of a partner under *I.R.C.* § 1014 (a) and (b) (6) until the partnership was terminated. The petitioners contest the Tax Court's ruling that the death of a partner does not, in and of itself, serve to terminate the partnership for tax purposes.

I. FACTS

Ernest Skaggs, decedent, and Carolyn C. Skaggs, his widow, conducted a farming business as equal partners in a two-member partnership known as the Santa Rita Ranch Company. They owned their respective capital interests in the partnership as community property. The partnership agreement provided that the partnership would terminate upon the death of either partner. The agreement also provided that, in such a case, the estate of the deceased partner could determine whether the partnership should elect to adjust the bases of the partnership assets under section 754 of the *I.R.C.*

The husband died on December 31, 1973, the last day of the partnership's 1973 tax year. Community property, including their respective partnership interests, became subject to probate administration. The wife was the sole beneficiary under the husband's will and was appointed executrix of his estate. No Section 754 election was filed by the partnership. Subsequent to December 31, 1973, the wife exercised full management control over the business. The debts outstanding as of December 31,

1973, were paid from subsequent crop income and collection of accounts receivable during the period between January 10, 1974 and September, 1974.

In their 1974 tax returns, the wife and the estate of her husband each reported one-half of the income and expenses derived from the farming operation in that year. In so doing, they assigned stepped-up basis, under § 1014 of the *I.R.C.*, to the crops sold and depreciable assests used in the business to reflect the fair market value of those items on the date of decedent's death. This had the effect of reducing the federal income tax for 1974 by $110,113 for the wife and $151,858 for the estate. The Commissioner disallowed the adjustment and the Tax Court affirmed.

II. DISCUSSION

The Tax Court's findings of fact and inferences drawn from those facts will be upset on appeal only if clearly erroneous, the appellant having the burden of showing such clear error. *Geneva Drive In Theatre, Inc. v. C.I.R.*, 622 F.2d 995 (9th Cir. 1980). Due to its special expertise, the Tax Court's determination should not be overruled unless some unmistakable question of law mandates such a decision. *Sibla v. C.I.R.*, 611 F.2d 1260 (9th Cir. 1980).

The petitioners argue that the partnership was terminated on December 31, 1973, the date of the husband's death. In a thorough opinion the Tax Court fully considered the petitioners arguments. See *Estate of Skaggs v. Commissioner*, 75 T.C. 191 (1980). Section 708 of the *Code and Treasury Regulation* 1.708-1 define when a partnership is terminated for federal income tax

purposes.[1] Under the regulations, a partnership does not terminate for tax purposes until the winding up of the partnership affairs have been completed. Further, the regulations indicate that the death of a partner does not necessarily terminate a partnership. *Treas. Reg.* § 1.708-1(b)(1)(i) and (iii)(a). The Tax Court found that although the partnership was dissolved on December 31, 1973, the process of terminating the partnership continued into 1974. *Id.* at 196. It concluded that absent a timely election under *I.R.C.* § 754, the bases of the partnership assets could not be adjusted on December 31, 1973.

We affirm.

---

[1] *Treas. Reg.* § 1.708-1, *Continuation of partnership.*

(a) *General rule.* For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) *Termination. General rule.* (i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. . . . [W]here partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

(a) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

(iii) For purposes of subchapter K, chapter 1 of the Code, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates.

The date of termination is:

(a) For purposes of section 708(b)(1)(A), the date on which the winding up of the partnership affairs is completed.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ESTATE OF ERNEST D. SKAGGS, Deceased,
CAROLYN C. FIKE, EXECUTRIX, AND
CAROLYN C. FIKE, FORMERLY
CAROLYN C. SKAGGS,

Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 81-7058

ORDER AMENDING OPINION
AND
DENYING REHEARING

COURT OF APPEALS
FOR THE NINTH CIRCUIT
FILED

MAY 27, 1982
PHILLIP B. WINBERRY, Clerk

By _____
Deputy

Before: FARRIS, FERGUSON, and NELSON, Circuit Judges.

The opinion filed in the above matter on March 24, 1982, is amended as follows:

At page 1265, right hand column, after "December 31, 1973," add footnote 2:

> [2]Our review is limited to these facts where a husband and wife executed a formal partnership agreement. The Tax Court decision and this decision neither deal with nor apply to an ordinary community property situation not involving a formal partnership agreement.

The panel as constituted above has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on it. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

OPINION OF THE UNITED STATES TAX COURT

ESTATE OF ERNEST D. SKAGGS, Deceased, CAROLYN C. FIKE, EXECUTRIX, AND CAROLYN C. FIKE, FORMERLY CAROLYN C. SKAGGS,

Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 6546-78. Filed October 30, 1980.

Held, unless a timely election was made under sec. 754, *I.R.C.* 1954, the bases of the assets of a California husband-wife partnership were not adjusted on the death of the husband under sec. 1014(a) and (b)(6), *I.R.C.* 1954, even though the bases of the interests of the respective partners were adjusted and both the deceased husband's interest and the surviving wife's interest were administered pursuant to State law under the supervision of the local superior court. *Held, further*, a purported election under sec. 754, *I.R.C.* 1954, to have the bases of the assets of the partnership adjusted for the calendar year 1973, made in the petition filed in the instant case, is not effective.

Philip H. Wile, for the petitioners.
Henry E. O'Neill, for the respondent.

OPINION

FEATHERSTON, *Judge:* Respondent determined deficiencies in petitioners' Federal income tax for 1974 as follows:

Petitioner	*Deficiency*
Estate of Ernest D. Skaggs	$151,858
Carolyn C. Fike	110,113

Due to concessions by petitioners, the following issues remain for decision:

(1) Whether certain assets held by a partnership, whose members, Ernest D. Skaggs and his wife, Carolyn (now Carolyn C. Fike), held their partnership interests as community property, were acquired from or passed from a decedent upon Ernest D. Skaggs' death so that the bases of the assets of the partnership were then adjusted under section 1014(a)[1] and (b)(6).

(2) If the bases of the assets were not adjusted at Ernest D. Skaggs' death, whether Carolyn C. Fike in the petition filed in the instant case made a valid election under section 754 to permit an adjustment in the bases of those assets pursuant to sections 743(b) and 755.

When the petition was filed, Carolyn C. Fike (petitioner), who has filed this action in her individual capacity and as executrix of the Will of Ernest D. Skaggs (Ernest), was a legal resident of Raymond, Calif. She filed 1974 Federal income tax returns for herself and for the estate with the Director, Fresno Service Center, Fresno, Calif.

Before his death on December 31, 1973, Ernest and petitioner, husband and wife, conducted a farming business as equal partners in a two-member partnership known as Santa Rita Ranch Co. (the partnership). They owned their capital interests in the partnership as community property. The

[1] All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

partnership maintained its records on the basis of a calendar year.

A written memorandum of partnership agreement was executed on April 22, 1967, and effective as of January 1, 1967. The partnership agreement (in article 8) provided that the partnership of Ernest and petitioner was to "terminate" on the death of either partner. It further provided (in article 10):

> In the event of the death of either partner at a time when the partnership shall not have already made the election provided in Section 754 of the Internal Revenue Code, as amended, to adjust the basis of the partnership property, the estate of such deceased partner shall be entitled to determine whether the partnership shall make such election and the remaining partner shall abide by such determination.

Prior to December 31, 1973, the partnership was engaged in farming 1,736 acres of land in Merced County, Calif., producing cotton, corn, sugar beets, alfalfa, and other annual crops. The land was leased by the partnership under an oral lease from Lillian Christiana. In July 1973, the partnership assumed control over the operation of certain property known as the "Raymond Ranch." This property was used primarily as grazing land under contractual arrangements with various cattle owners who were permintted to graze their cattle on the property for prescribed fees.

As of December 31, 1973, when Ernest died, the partnership owned certain depreciable assets and certain crops. At that time, the partnership held 435 bales of harvested but unsold cotton, a sugar beet crop, then estimated at 11,550 tons, which was in the ground subject to harvest in the spring of 1974, and accounts receivable for corn and milo harvested and delivered but not yet paid for by purchasers. The partnership was heavily

indebted to the Bank of America for crop loans in the amount of $158,000 to cover the cost of producing 1973 crops which had not yet been sold or for which sales proceeds had not yet been collected. Additional debts in the amount of $47,687.14 were outstanding. To realize proceeds from the crop assets and to repay the bank loan, it was essential that business operations conducted by the partnership prior to December 31, 1973, be continued for the purposes of collecting the receivables, selling unsold crops, and harvesting and selling the beet crop.

No notice of dissolution of the partnership was published in any newspaper. Nor was any affidavit showing the publication of such a notice filed with the county clerk.

All of the community property owned by Ernest and petitioner at the date of his death, including both the partnership interest of Ernest and that of petitioner, became subject to probate administration in the Merced County Superior Court (hereinafter the Superior Court). Under Ernest's will, which was admitted to probate on February 4, 1974, petitioner was authorized to carry on the farming business owned by the partnership. On February 28, 1974, as executrix, she filed a petition with the Superior Court seeking authority to continue the farming operation, and her petition was granted on March 15, 1974. From December 31, 1973, as executrix, petitioner exercised full management control over the farming business and operations. She completed the sale of crops produced in 1973, collected the proceeds from the sale of those crops, handled the production and sale of crops maturing in 1974, and began preparations for the production of 1975 crops. The debts outstanding as of December 31, 1973, were paid from crop income and from collection of accounts receivable or were otherwise discharged during the period beginning January 10,

1974, and ended September 1974.

On November 7, 1974, Santa Rita Farms, Inc., was incorporated, and the corporation leased the farm property which had been leased and operated by the partnership. The lease to the corporation preserved for "the prior tenant" the right to harvest crops still growing on the land on November 7, 1974. The corporation paid Ernest's estate $70,000 to reimburse it for expenses paid with respect to future crops not ready for harvest on November 8, 1974. The farming business conducted under petitioner's supervision was continued to complete the harvest and sale of the crops not conveyed to the corporation and to pay expenses incurred in the business.

On December 6, 1974, petitioner acquired 500 shares of the capital stock of Santa Rita Farms, Inc., all of the shares issued prior to February 27, 1975. Before February 10, 1975, all obligations of the farming business had been discharged. On February 27, 1975, she acquired an additional 15,000 shares in exchange for certain equipment and additions to rented farm labor houses, all of which was used in the farming business of the partnership before Ernest's death. These items were distributed to petitioner in her individual capacity from the estate pursuant to court order on February 26, 1975.

Federal and State income tax returns for the partnership were filed for 1973. Pursuant to advice of counsel, no further partnership returns were filed for the partnership and no election under section 754 was filed on any return. No application for an extension of time for filing either the 1973 partnership return or a section 754 election was ever made.

The estate and petitioner filed 1974 Federal income tax returns, each of which reported one-half of the 1974 collections and crop income. In reporting income derived from the sale of

crops during 1974, new bases were claimed by the estate and by petitioner in an amount equal to the fair market value of the crops on hand as of December 31, 1973. The claimed bases represented a total increase of $415,936 over the bases of the same assets in the hands of the partnership prior to December 31, 1973. No basis was claimed with respect to the accounts receivable.[2] Depreciation deductions claimed by Ernest's estate and petitioner for the period of the continued operation of the farming business were computed on an amount equal to the fair market value of the depreciable assets as of December 31, 1973.

In the notices of deficiency issued to petitioner and to Ernest's estate, respectively, respondent made the following determination:

> The deduction of $207,968.00 claimed as basis in growing crops is not allowed because it has not been established that you acquired such assets from the decedent within the provisions of section 1014 of the Internal Revenue Code of 1954. Accordingly, your taxable income is increased by $207,968.00.

Due to this denial of the claimed adjustment in basis, respondent also disallowed a portion of the depreciation claimed on assets used in the farming business. In her petition filed June 16, 1978, petitioner sought to elect under section 754 to adjust the bases of partnership assets pursuant to section 743(b).

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[2]The accounts receivable were "income in respect of a decedent" under sec. 691, and under secs. 741 and 1014(c) did not receive a step-up in basis. *Quick's Trust v. Commissioner*, 444 F.2d 90, 92 (8th Cir. 1971), affg. per curiam 54 T.C. 1336 (1970). Accord, *Woodhall v. Commissioner*, 454 F.2d 226, 228-229 (9th Cir. 1972), affg. a Memorandum Opinion of this Court. H. Rept. 1337, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. 70-71 (1954).

1. Section 1014 Basis Adjustment

The parties agree that under subsection (a) of section 1014,[3] as in effect during the period in issue, the basis of property which was acquired from or which passed from a decedent is generally its fair market value at decedent's death. In the case of community property which was held by a decedent and by a surviving spouse and at least one-half of which was includable in the decedent's gross estate, subsection (b)(6)[4] of that section provides that the surviving spouse's one-half share of the community property shall be treated as property acquired from the decedent and its basis shall also be adjusted. See sec. 1.1014-2(c)(2), Income Tax Regs. The parties differ, however, as to what property of the decedent in the instant case qualifies for the basis

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[3]SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) IN GENERAL.-Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death * * *

[4]Sec. 1014(b) provides that-
the following property shall be considered to have been acquired from or to have passed from the decedent:

* * * * * * * * *

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

adjustment.

According to respondent, the community property held by petitioner and Ernest at his death was not the partnership assets but rather the partnership interests. Citing section 708(a) and (b)(1), he contends that the partnership continued after Ernest's death and that the assets therefore continued to be held in tenancy in partnership. Although the partnership interests qualified for the section 1014 basis adjustment, in respondent's view, a corresponding adjustment in the bases of the partnership assets could be effected only by a partnership election under section 754. Because that election was not timely made by the partnership, respondent argues, the section 1014 basis adjustment applies only to the partnership interests.

In petitioner's view, the partnership terminated on Ernest's death under the terms of the partnership agreement as well as under the principles of Federal tax and California law. Upon termination, the community property subject to probate administration in Ernest's estate included, petitioner contends, the partnership assets as well as the partnership interests. Therefore, the argument goes, the bases of the partnership assets are adjusted under section 1014.

We uphold respondent's determination. While, at first blush, it may seem incongruous that this husband-wife partnership continued after Ernest's death until its affairs were wound up, we think it quite clearly did.

The parties have stipulated that petitioner and Ernest owned their partnership interests as community property at Ernest's death. Those interests, as the parties agree, thus qualify for basis adjustments under section 1014(a) and (b)(6). Petitioner does not contend, and the record does not show, that any of the partnership assets were distributed to Ernest before his death, and the bases of those assets, not the partnership

interests, are here at issue.

Under California law, Ernest's death did not cause the specific partnership assets, as distinguished from the partnership interests, to pass from him or his estate to petitioner. A partner's interest in a partnership under California law is "his share of the profits and surplus," and he is "co-owner with his partners of specific partnership property," holding, however, as a "tenant in the partnership." Cal. Corp. Code secs. 15024, 15025(1), 15026(West 1977).[5] *Kenworthy v. Hadden*, 87 Cal. App. 3d 696, 151 Cal. Rptr. 169, 172(3d Dist. Ct. App. 1978). Unless the partners have provided otherwise in a written agreement which they have all signed, the death of a member does not cause an immediate distribution of the partnership assets but causes a firm dissolution, which is defined as "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." Cal. Corp. Code secs. 15029, 15031(4) (West 1977).

Upon the dissolution of a partnership, a partner has the right to an accounting of the value of his partnership interest, in

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[5]Sec. 15024. Property rights

The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management.

Sec. 15025. Ownership of specific partnership property

(1) Co-owner; tenancy in partnership. A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

Sec. 15026. Interest in partnership

A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property.

other words, the value of his ratable share of firm profits and surplus remaining after both satisfaction of creditors' claims against the partnership and an accounting between the partners. Cal. Corp. Code secs. 15038, 15040, 15042, 15043 (West 1977). Dissolution does not, however, vest the partners with ownership in specific partnership assets. *Comstock v. Fiorella*, 67 Cal. Rptr. 104, 105-106 (4th Dist. Ct. App. 1968). Indeed, even when a husband-wife partnership is dissolved by the death of the husband, partnership "assets, debts, and credits remain distinct from those of its late members." *Electric Equipment Co. v. Heineman*, 7 Cal. App. 2d 792, 45 P.2d 830,831 (2d Dist. Ct. App. 1935).[6]

The record contains no written agreement providing that dissolution would not occur at the death of either petitioner or Ernest. Therefore, it is clear that, under California law, Ernest's death caused a dissolution. The dissolution did not, however, transform the interests of Ernest and petitioner in the firm assets into direct ownership of those assets. The liquidation of the partnership or the winding up of its affairs remained to be

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[6]In *Electric Equipment Co. v. Heineman*, 7 Cal. App. 2d. 792, 45 P.2d 830, 831 (2d Dist. Ct. App. 1935), involving a husband-wife partnership, the court explained:

"When a partnership is dissolved by the death of one of the partners, its assets, debts, and credits remain distinct from those of its late members. The surviving partners should proceed to wind up the affairs of the partnership, pay its debts out of the assets, and divide the residue, if any, among those who are entitled thereto."

This case arose under the State law as it stood prior to the adoption of the California version of the uniform partnership law, but its holding is consistent with the law as it stood at Ernest's death.

accomplished. Hence, it cannot be said that, by operation of California law, the partnership assets became property acquired from or passing from decedent, within the meaning of section 1014.

Significantly, moreover, the Internal Revenue Code, not State law, determines who is a partners and what is a partnership for Federal tax purposes. Secs. 761(a) and (b), 7701 (a)(2). *Evans v. Commissioner*, 447 F.2d 547, 550, 552(7th Cir. 1971), affg. 54 T.C. 40 (1970); *Baker Commodities, Inc. v. Commissioner*, 415 F.2d 519, 525 (9th Cir. 1969), affg. 48 T.C. 374 (1967), cert. denied 397 U.S. 988 (1970). And it is clear that on December 31,1973, the partnership did not terminate, within the meaning of section 708[7] (the Code provision which determines whether a partnership is considered as terminated). A partnership is "considered" as terminated "only if," in pertinent part, no part of its business "continues to be carried on by any of its partners in a partnership." Sec. 708(b)(1)(A); sec. 1.708-1(b)(1)(i), Income Tax Regs. With respect to a two-member partnership, the regulations expressly provide that the firm shall not be considered as terminated upon the death of one partner if the estate or other successor in interest of the deceased partner

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[7] SEC. 708. CONTINUATION OF PARTNERSHIP.

(a) GENERAL RULE.-For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION.-

(1) GENERAL RULE.-For purposes of subsection (a), a partnership shall be considered as terminated only if-

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

"continues to share in the profits or losses of the partnership business." Sec. 1.708-1(b)(1)(i)(a), Income Tax Regs.[8] *Haines v. United States*, an unreported opinion (D. N.J. 1976, 37 AFTR 2d 76-768, 76-1 USTC par. 9222.)[9]

When Ernest died, as stated above, the partnership owed debts in excess of $200,000. Unless otherwise discharged after his death, those partnership debts were paid in 1974 from crop income and collections of accounts receivable of the farming business.[10] Payment of the partnership debts relieved the estate

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[8]Sec. 1.708-1(b)(1)(i)(a), Income Tax Regs., provides as follows:

"Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business."

[9]In *Glassell v. Prentiss*, 175 Cal. App. 2d 599, 346 P.2d 895, 901 (4th Dist. Ct. App. 1959), the court explained:

"In settling accounts between partners after dissolution, the liabilities of the partnership to creditors first must be paid; secondly, the liabilities owing to partners other than for capital and profits, and thereafter the liabilities owing to partners in respect to capital and profits. * * *
If there is not sufficient partnership property to satisfy the liabilities, each partner must contribute his share towards such satisfaction, and any partner who contributes more than his share may recover from a defaulting partner the amount which was paid in excess of his liability. * * *"

See also Cal. Corp. Code sec. 15036(4) (West 1977).

[10]The second report of petitioner, as executrix, filed in the Superior Court, as well as the Court's order approving her report, shows that only one creditor's claim was filed against the estate as such-a claim by petitioner herself in the amount of $4,182.45. The partnership's debts thus were not treated as debts of the estate. Nor is there any evidence in that report or any of the other Superior Court documents in evidence indicating that the proceeds of the partnership crops were controlled by, or even reported to, the court.

of liability for them. Ernest's and petitioner's one-half shares of the partnership interests remained in the partnership subject to creditors' claims after December 31, 1973.[11] Indeed, the 1974 return filed by the estate shows that the estate treated as its own one-half of the collections and the crop income. Accordingly, it is clear that Ernest's estate continued to share in the profits of the partnership business and that the partnership, within the meaning of section 708(a) and (b)(1), did not terminate until after Ernest's death. Sec. 1.708-1(b)(1)(i)(a), Income Tax Regs.

Conceding that the farming business was continued after Ernest's death, petitioner would distinguish cases addressing the issue whether post-dissolution activities were sufficient to constitute continuation of a partnership under section 708. *Baker Commodities, Inc. v. Commissioner*, 415 F.2d 519 (9th Cir. 1969), affg. 48 T.C. 374 (1967), cert. denied 397 U.S. 988 (1970); *Foxman v. Commissioner*, 41 T.C. 535 (1964), affd. 352 F.2d 466 (3d Cir. 1965); *Ginsberg v. United States*, 184 Ct. Cl. 444, 396 F.2d 983 (1968). While the post-December 31, 1973, business activities in the instant case were extensive, our conclusion that the two-member partnership did not terminate for Federal tax purposes is based not on the extent of activity conducted, but on the facts that the partnership was not wound up at Ernest's death and the estate continued to share in the partnership profits or losses. Therefore, we do not discuss petitioner

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[11]One commentator has opined that the estate shares in partnership profits or losses if the decedent's capital interest remains in the partnership subject to claims of partnership creditors. W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, par. 12.04[2], n. 34 (1977).

petitioner's attempts to distinguish other cases to which section 1.708-1(b)(1)(i)(a), Income Tax Regs., does not apply. *Evans v. Commissioner, supra; Maxcy v. Commissioner,* 59 T.C. 716 (1973); *Estate of Panero v. Commissioner,* 48 T.C. 147 (1967).[12]

Petitioner has cited no provision of the Internal Revenue Code, and we know of none, which would characterize the partnership assets as property qualifying for the section 1014(a) and (b)(6) basis adjustment, i.e, property acquired from a decedent or property in the hands of a person to whom it passed from a decedent. To the contrary, subchapter K of chapter 1 of the Code expressly contemplates a situation in which the basis of a partnership interest is adjusted under section 1014 while the bases of firm assets are unchanged. Section 743(a) provides that:

> The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership * * * on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

Estate of Dupree v. United States, 391 F.2d 753, 758 (5th Cir. 1968). Thus, only after filing a timely section 754 election may the

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[12]The deemed distribution of partnership property, described in sec. 1.708-1(b)(1)(iv), Income Tax Regs., does not apply in the instant case. Such a deemed distribution applies "if a partnership is terminated by a sale or exchange of an interest." A disposition of a partnership interest by bequest or inheritance is not a sale or exchange of an interest, within the meaning of the regulation. Sec. 1.708-1(b)(1)(ii), Income Tax Regs.

firm adjust the bases of partnership assets under section 743(b)[13] with respect to the transferee partner. Courts have recongnized that under these Code sections, in the absence of a valid election, the transferee of a partnership interest may have a basis for that interest far larger than his ratable share of the adjusted basis of partnership property. *Estate of Dupree v. United States*, 391 F.2d at 758; *Jones v. United States*, 213 Ct. Cl. 529, 532 and n. 3,553 F.2d 667, 668 (1977).

As we understand her argument, petitioner links together several Federal income tax and State law provisions to support her theory that the bases of partnership assets were adjusted at Ernest's death. She first argues that the partnership was terminated on December 31, 1973. We have pointed out that Ernest's estate continued to share in the profits of the partnership and that it did not, therefore, terminate for Federal

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[13]SEC. 743. OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.

(b) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.- In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall-

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) Decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary or his delegate, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. * * *

tax purposes. Citing article 8 of the partnership agreement, which provided that "the partnership shall terminate upon the death of either partner," however, petitioner argues that the partnership terminated at Ernest's death. Yet article 10 of the agreement, set out above, provides that the estate of a deceased partner is entitled to determine whether the partnership will, if it has not already done so, elect under section 754 to adjust the bases of partnership property. Implicit in this provision is an assumption that the partnership would continue for some period of time after the death of one of the two partners.

As we construe the agreement as a whole, the word "terminate" as used in article 8 denotes not an immediate termination within the meaning of either California partnership law or subchapter K but rather a dissolution to be followed in due course by a winding up of partnership affairs. A dissolution is not synonymous with a termination. Rather a dissolved partnership "continues until the winding up of partnership affairs is completed." Cal. Corp. Code secs. 15030, 15031(4) (West 1977).[14] *Yahr-Donen Corp. v. Crocker*, 80 Cal. App. 2d 788, 182 P.2d 209, 211 (2d Dist. Ct. App. 1947). Winding up involves payment of partnership liabilities and settling of accounts between the partners. Cal. Corp. Code Secs. 15038, 15040, 15041 (West 1977); *Comstock v. Fiorello*, 260 Cal. App. 2d 262,

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[14]Sec. 15030. Effect of dissolution

On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.

Sec. 15031. Causes of dissolution

Dissolution is caused:

(4) By the death of any partner unless otherwise provided in an agreement in writing signed by all the partners before such death;

67 Cal. Rptr. 104, 106 (4th Dist. Ct. App. 1968); *Glassell v. Prentiss*, 175 Cal. App. 2d 599, 346 P.2d 895, 901 (4th Dist. Ct. App. 1959).

As stated above, the partnership had on hand accounts receivable, harvested crops, and growing crops as well as other assets and had large amounts of indebtness outstanding on December 31, 1973, when Ernest died. The crops were not all sold for several months, and the liabilities were not fully discharged until September 1974. Hence, the partnership was dissolved but was not terminated at Ernest's death.

Since the winding up of the partnership was not completed at Ernest's death, the partnership did not then terminate even if, as petitioner contends, her conduct of the farming business after December 31, 1973, exceeded the authority of a surviving partner to wind up partnership affairs. As petitioner acknowledges, the partnership is bound even on transactions undertaken by a surviving partner in excess of the authority conferred by Cal. Corp. Code secs. 15033 and 15035(1) (West 1977) if the other party to the tansaction knew of the partnership prior to dissolution, had no knowledge or notice of the dissolution, and, in the case of one who was not prior partnership creditor, the fact of dissolution had not been advertised in a newspaper in accordance with Cal. Corp. Code secs. 15035(1)(b)(II) and 15035.5 (West 1977).

The record does not reveal (i.e., petitioner has not carried the burden of proving) who are the other parties to those transactions which petitioner describes as outside the scope of winding up the partnership, whether those parties knew of the partnership prior to dissolution, or whether they had notice or knowledge of dissolution. However, the parties have stipulated

that no notice of dissolution was published. In fact, as the parties have stipulated, the name "Santa Rita Ranch Co." was used in continuing the business "in a conscious effort to create an impression of continuity with third parties." All bank accounts maintained by the partnership before December 31, 1973, were kept in the name of Santa Rita Ranch Co. Checks on those accounts bore no notation that the accounts had become those of Ernest's estate. We cannot, therefore, conclude that the partnership was not bound by these transactions under California law.

Petitioner further cites Cal. Prob. Code sec. 202 (West 1956),[15] and Cal. Civ. Code sec. 5125 (West 1970),[16] which, as in effect in 1973, subjected both the husband's and the wife's shares of community personal property, including partnership interests, to probate administration upon the husband's death. Petitioner states that she applied for and was granted permission by the Superior Court to continue the farming business in her capacity as executrix of the estate. The Superior Court, she argues, treated the partnership as terminated and its assets as community property administered in the estate. On this theory, petitioner concludes that the farming business became part of

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[15]Cal. Prob. Code sec. 202(West 1956) provided in part that:

"Community property passing from the control of the husband * * * by reason of his death * * * is subject * * * to administration and disposal under the provisions of Division 3 [Administration of Estates of Decedents] of this code * * *"

[16]Cal. Civ. Code sec. 5125 (West 1970) provided in part that:

"the husband has the management and control of the community personal property * * * *"

the estate and was carried on in Ernest's estate and by his executrix rather than in the partnership and by a partner for State law purposes. Noting that Federal income tax law determines the existence and termination of a partnership but that local law governs in determining the legal relationships of partners and their interests in partnership assets (sec. 301.7701-1(c), Proced. & Admin. Regs.), she maintains that the partnership is, therefore, considered as terminated under section 708(b)(1)(A), quoted in note 7 *supra*, for Federal tax purposes as well.

We agree with petitioner that both her and Ernest's partnership interests were subject to probate administration in Ernest's estate. By stating that the executrix controls the assets in the estate subject to court jurisdiction, however, she misconstrues both Cal. Prob. Code sec. 300 (West 1956), and the cases on which she relies. Under these authorities, the executrix, as an officer of the court, merely has possession; the Superior Court controls the assets. *In re Estate of Cole*, 240 Cal. App. 2d 324, 49 Cal. Rptr. 419, 423 (1st Dist. Ct. App. 1966); *In re Algee's Estate*, 158 Cal. App. 2d 691, 323 P.2d 221, 226 (2d Dist. Ct. App. 1958). Though administered in the probate court, petitioner's half interest in the partnership never became a part of Ernest's estate.[17] Subjecting the partnership interests to

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[17] In *Bishop v. Commissioner*, 152 F.2d 389, 391 (9th Cir. 1945), revg. and remanding 4 T.C. 588 (1945), the court explained:

"The Tax Court appears to have assumed that, upon decedent's death, petitioner's half of the community property ceased to be hers and became a part of decedent's estate. The assumption is incorrect. Petitioner's half, like decedent's half, was subject to administration, but, unlike his half, her half never became a part of his estate. [Fn. refs. omitted.]"

probate administration, moreover, did not effectuate a liquidation of the partnership and the winding up of its affairs. That remained to be done.

We do not agree with petitioner's further argument that she is taxable on one-half the income from the farming business not "as a partner in a continuing partnership" but as the surviving spouse whose one-half the interest in the community property was subject to probate administration in Ernest's estate. *Bishop v. Commissioner*, 152 F.2d 389, 390 (9th Cir. 1945), revg. and remanding 4 T.C. 588 (1945), cited by petitioner, does not support that position. Construing California law, the *Bishop* court held that the taxpayer's one-half share of community property, although subject to probate administration in her husband's estate, belonged to her after, as well as before, her husband's death. Therefore, income attributable to that share was taxable to her. *Bishop v. Commissioner, supra* at 390-391. Our conclusions that petitioner remained the owner of her partnership interest until the affairs of the partnership were wound up and that the partnership continued after December 31, 1973, for State law as well as Federal tax purposes are consistent with that case.

Moreover, the fact that petitioner applied for and was granted authority from the Superior Court to operate the farming business does not, as she maintains, mean that she had no authority under California law to operate the partnership as surviving partner. As our discussion above indicates, she was able to bind the partnership on the transactions she undertook after December 31, 1973. California partnership law expressly provides (Cal. Corp. Code sec. 15045 (West 1977):

The rights and duties of surviving partners, the legal representatives of deceased partners, the creditors of such partners, and the creditors of the partnership * * * shall be given full force and effect notwithstanding any provision inconsistent therewith in the Probate Code * * *

Therefore, we cannot, as petitioner would have us, conclude that, under State law, the farming business was operated in the estate by the executrix rather than in a partnership by a partner.

It is true, as petitioner observes, that the Superior Court stated in its order dated March 15, 1974, that the partnership terminated upon Ernest's death, and that the partnership assets, as community property of decedent and petitioner, became subject to the jurisdiction of that court as a part of the community property estate. However, the Superior Court made that statement not in adjudicating whether the partnership terminated under State law or whether the bases of its assets were adjusted for Federal tax purposes but rather in the course of administering Ernest's estate. There is nothing in the record to indicate that this issue was litigated in the Superior Court. The Superior Court's statement is to be weighed in the light of the facts that, as of December 31, 1973, the affairs of the partnership had not been wound up, that its debts were paid during 1974 from its farm crop proceeds, and that the estate and petitioner individually were thereby relieved of debts which would otherwise have fallen on the estate and petitioner. Sec. 1.708-1(b)(1)(i)(a), Income Tax Regs. And, indeed, the partnership debts were not treated by that court as debts of the estate but rather were handled apart from the estate. The Superior Court's statement thus is not dispositive of the issue before us.

2. Section 754 Election

If the bases of the partnership assets were not adjusted at Ernest's death under section 1014, petitioner acknowledges that the bases reported in the 1974 returns filed by her and by the estate were correct only if an election under section 754 was made. Although filed in neither the time period nor the manner prescribed by section 1.754-1, Income Tax Regs., a valid election was, in her view, filed in the petition in this case. Respondent, on the other hand, maintains that the purported election, which was neither timely nor made by the partnership, fails two requirements of the regulation. We hold that the purported election was not valid because it was not filed by the partnership in a timely partnership return as required by section 1.754-1(b)(1), Income Tax Regs.

In the case of a transfer of a partnership interest, the basis of partnership property is adjusted with respect to the transferee if the partnership files an election "in accordance with regulations prescribed by the Secretary." Sec. 754.[18] In the instant case, the

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[18]SEC. 754. MANNER OF ELECTING OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.

If a partnership files an election, in accordance with regulations prescribed by the Secretary or his delegate, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulation prescribed by the Secretary or his delegate.

partnership did not file an election. Moreover, under the regulations, such an election "shall be made in a written statement filed with the partnership return for the taxable year during which the * * * transfer occurs." Sec. 1.754-1(b)(1), Income Tax Regs.[19]

This regulation has been upheld as not unreasonable or plainly inconistent with the revenue statutes. *Jones v. United States*, 213 Ct. Cl. 529, 537, 553 F.2d 667, 671, (1977). In that opinion, the Court of Claims noted that a proposed version of section 743 contained the requirement that the election be filed with the partnership return for the year of the transfer, the same requirement embodied in the regulation under section 754 (213 Ct. Cl. at 536, 553 F.2d at 671). Construing the regulation, the court held that the election must be timely made with the original return for the year of the transfer or in an amended return filed within the statutory period for filing the original return. *Jones v. United States*, 213 Ct. Cl. at 539, 553 F.2d at 672. Accord, *Estate of Dupree v. United States*, 391 F.2d 753, 759 (5th Cir. 1968) (without reaching issue whether election must be filed only with return for the year of the transfer, the court cited same time

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[19]Sec. 1.754-1 Time and manner of making election to adjust basis of partnership property.

(b) *Time and method of making election.* (1) An election under section 754 and this section to adjust the basis of partnership property under section 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of sec. 1.6031-1 (including extensions thereof) for filing the return for such taxable year (or before August 23, 1956, whichever is later). * * *

period with respect to return with which purported election was filed). A similar regulation has been upheld under another Code Section. *National Western Life Insurance Co. v. Commissioner*, 54 T.C. 33, 40 (1970) (sec. 1.818-4(e), Income Tax Regs.).

Here, the tansfer occurred at Ernest's death. No election was filed with the partnership return for 1973. The purported election was filed as part of the petition in this proceeding on June 16, 1978, more than 4 years after the period for filing the 1973 partnership return and thus even later than the purported election in *Jones*.

Petitioner does not, as did the taxpayer in the *Jones* case, contend that the time period prescribed by the regulation allowed insufficient time to decide whether to elect under section 754. The Court of Claims rebutted the argument in that case, in part, by noting that no extension of time to file the partnership return or the election was ever requested. Similarly, neither the partnership nor petitioner in the instant case ever requested an extension of time to file the return or the election.

According to petitioner, a line of installment method election cases (*Mamula v. Commissioner*, 346 F.2d 1016 (9th Cir. 1965), revg. and remanding 41 T.C. 572 (1964); *Scales v. Commissioner*, 211, F.2d 133 (6th Cir. 1954), revg. and remanding 18 T.C. 1263 (1952); *Bayley v. Commissioner*, 35,T.C. 288 (1960); *Estate of Broadhead v. Commissioner*, T.C. Memo. 1972-195), holds that a late election is valid if the taxpayer reasonably relied on a characterization of the transaction which would not entail an election and if the election later became necessary for the first time after determination of deficiencies. Returning to her arguments with respect to the first issue in this case, petitioner characterizes the failure to elect as reasonable

and maintains that the election became necessary only when respondent determined that the bases of partnership assets were not adjusted at Ernest's death.

We do not agree that these cases stand for the foregoing broad proposition. They are all distinguishable from the case before us. The taxpayer in *Mamula* originally reported gain on the sale of real estate on the basis of an accounting method *not* allowed by the regulations under section 453(b). Permitting the taxpayer to belatedly elect the installment method, the Ninth Circuit stated that a late election could be made if the original election was invalid. Furthermore, it deemed the regulation under section 453 inapplicable to the case before it. Here the initial failure to elect under section 754 was not invalid as the basis adjustment is optional.

In *Bayley* and *Estate of Broadhead*, this Court relied in part on the Commissioner's published position in Rev. Rul. 56-396, 1956-2 C.B. 298, and Rev. Rul. 65-297, 1965-2 C.B. 152, respectively, that a taxpayer could elect installment method treatment even if he failed to comply with section 1.453-8(b)(1), Income Tax Regs. No such concession applies to the instant case. In *Scales*, the Sixth Circuit cited its opinion in *United States v. Eversman*, 133 F.2d 261, 266 (6th Cir. 1943), which held that section 44(b) and (d), the relevant Code provision, contained no requirement that an express election be made in the tax return. As this Court has observed, neither did the regulations applicable in *Scales* and *Eversman* require an

election in the income tax return. *Reaver v. Commissioner*, 42 T.C. 72, 78-80 (1964). In contrast, the regulations under section 754 contain such a requirement.

Summarizing, section 754 authorizes the coveted basis adjustment only if the "partnership files an election" and only if the election is filed "in accordance with regulations prescribed by the Secretary or his delegate." The partnership did not file an election in this case. The only purported election was that filed by petitioner on June 16, 1978, in the petition herein. By that time, indeed by not later than February 26, 1975, the partnership partnership had ceased to exist: its assets had been sold or transferred to Santa Rita Farms, Inc.; its debts had been paid; and the assets of Ernest's estate had been distributed. Moreover, the election was not made in a written statement filed with a timely return for the partnership for the taxable year during which the distribution or transfer occurred as required by the regulation. We are compelled, therefore, to hold that a valid basis adjustment election was not made pursuant to section 754.

To reflect the foregoing,

Decision will be entered for the respondent.

Internal Revenue Code Sections:

Sec. 708. **Continuation of Partnership**

(a) GENERAL RULE. For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION.

(1) GENERAL RULE. For purposes of subsection (a), a partnership shall be considered as terminated only if--

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

(2) SPECIAL RULES.

(A) MERGER OR CONSOLIDATION. In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

(B) DIVISION OF A PARTNERSHIP. In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in capital and profits of the prior partnership) shall, for the purposes of this section, be considered a continuation of the prior partnership.

Sec. 743. **Optional Adjustment to Basis of Partnership Property.**

(a) GENERAL RULE. The basis of partnership property shall not be adjustd as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

(b) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY. In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall--

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of an agreement described in section 704 (c) (2) (relating to effect of partnership agreement on contributed property), such share shall be

determined by taking such agreement into account. In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

Sec. 754. **Manner of Electing Optional Adjustment to Basis of Partnership Property.**

If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734, and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interest in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.

Treasury Regulations on Income Taxes:

§1.708-1(a) to 1.708-1(b) (l) (i) (a) CONTINUATION OF PARTNERSHIP.

(a) GENERAL RULE. For the purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION (1) GENERAL RULE. (i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of ceasing of business until September 30, 1957.

(a) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

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In the Supreme Court of the United States

OCTOBER TERM, 1982

CAROLYN C. FIKE, EXECUTRIX OF THE ESTATE OF ERNEST D. SKAGGS, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The question presented in this federal income tax case is whether the courts below correctly held that a two-member partnership did not terminate at the moment of one partner's death so that only the basis of the decedent's interest in the partnership, and not the bases of the underlying partnership assets, could be increased to date-of-death value under Section 1014 of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts may be summarized as follows: Prior to December 31, 1973, Ernest and Carolyn Skaggs, husband and wife and residents of California, conducted a farming business as equal partners in a partnership known as the Santa Rita Ranch Company. Their partnership interests were held as community property. The partnership agreement provided that the partnership was to terminate upon the death of either partner, but also stated that the

estate of the deceased partner could then determine whether the partnership should elect to adjust the basis of partnership property pursuant to Section 754 of the Internal Revenue Code of 1954 (26 U.S.C.) (Pet. App. A-8 to A-9).

Ernest Skaggs died on December 31, 1973. All of the community property owned by decedent and Carolyn, including their partnership interests, became subject to probate administration. Carolyn was the sole beneficiary of decedent's will and executrix of his estate. It was essential to continue operation of the farming business after decedent's death in order to complete the 1973 crop season and to discharge outstanding partnership liabilities. Carolyn thereafter exercised full management control over the business by collecting accounts receivable, selling crops and beginning the preparation for the production of the next year's crops. The debts outstanding as of December 31, 1973, were paid from receipts collected between January 10, 1974, and September, 1974. No notice of dissolution of the partnership was ever published after decedent's death, and the farming business continued under the partnership name (Pet. App. A-9 to A-11).

On their 1974 tax returns, Carolyn and decedent's estate each reported one-half of the income and expenses derived from the farming operation in that year. In so doing, they assigned stepped-up bases, under Section 1014 of the Internal Revenue Code of 1954 (26 U.S.C.), to the crops sold and to the depreciable assets used in the business, reflecting the fair market value of those items on the date of decedent's death. On audit, the Commissioner of Internal Revenue rejected petitioners' proposed basis adjustments and increased taxable income for that year accordingly (Pet. App. A-11 to A-12).

The Tax Court upheld the Commissioner's determinations. It ruled that the death of decedent did not instantaneously terminate the partnership and that, since no

valid election was made under Section 754 of the Code, the base of the partnership assets could not be adjusted to reflect their fair market value on the date of Ernest's death (Pet. App. A-13 to A-32). The court of appeals affirmed[1] (Pet. App. A-1 to A-6).

1. The decision below correctly held that the partnership assets could not be assigned stepped-up bases reflecting their fair market value on the date of decedent's death under Section 1014(a) of the Code. That statute provides that property acquired or passed from a decedent may take a new basis equal to the date-of-death value of the property in question. Moreover, in the case of community property, this adjustment to basis also applies, under the provisions of Section 1014(b)(6), to the surviving spouse's share of the property in question. Pursuant to Section 743, however, where an interest in a partnership is transferred on the death of a partner, such a basis adjustment is permitted only with respect to the partnership interest itself, and not with respect to the underlying partnership assets unless the partnership makes the election provided for in Section 754.

Petitioners now acknowledge (Pet. 3) that the partnership did not make a valid Section 754 election.[2] They argue, however, that such an election was unnecessary on the theory that the partnership was immediately terminated and its assets distributed to Carolyn, as executrix of decedent's estate, at the moment of decedent's death and, therefore, the partnership assets—and not the decedent's partnership interest—were transferred to his estate for purposes of Sections 743(a) and 1014.

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[1] The opinion of the court of appeals is reported at 672 F.2d 756.

[2] In the Tax Court, Carolyn and decedent's estate contended that a belated attempt to make an election under Section 754 should be honored. They did not renew that contention on appeal.

As the court of appeals noted (Pet. App. A-3 to A-4), however, the termination of a partnership for federal tax purposes is governed by Section 708 of the Code. Specifically, Section 708(b)(1)(A) provides that a partnership is considered to be terminated only if "no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership." See *Austin* v. *United States*, 461 F.2d 733, 737 (10th Cir. 1972); *Baker Commodities, Inc.* v. *Commissioner*, 415 F.2d 519, 526-527 (9th Cir. 1969), cert. denied, 397 U.S. 988 (1970). Similarly, Treasury Regulations on Income Tax (1954 Code), Sections 1.708-1(b)(1)(i) and (iii)(*a*) (26 C.F.R.), provide that, notwithstanding a dissolution, a partnership does not terminate for federal tax purposes until the winding up of partnership affairs has been completed. Thus, even upon the death of a partner in a two-member partnership, as here, the partnership is not effectively terminated as long as the estate of the deceased partner continues to share in the profits and losses of the partnership business. Treasury Regulations on Income Tax (1954 Code), Section 1.708-1(b)(1)(i)(*a*) (26 C.F.R.); *Haines* v. *United States*, 76-1 U.S. Tax Cas. para. 9222 (1976).

The facts in this case establish that the partnership here did not terminate at the moment of decedent's death. Between December 31, 1973, and, at the least, September 1974, Carolyn continued the farming business in order to discharge the partnership's outstanding obligations. Indeed, she apparently made no attempt to notify its customers or creditors that the business had undergone a change in form. Moreover, decedent's estate in its 1974 return treated as its own, one-half of the partnership income for that year. Since the estate continued to share in the profits of the business, the partnership did not terminate until some time after decedent's death.

2. The crux of petitioners' argument is that the decision below is nevertheless contrary to California law. Specifically, petitioners argue (Pet. 5-9) that upon Ernest's death only one person, i.e., Carolyn as executrix of his estate, had the legal right under California law to possess and use the partnership assets, and that the partnership must, therefore, have terminated at that time.

But there is no basis for inferring that Congress intended that the question of the continued existence of the partnership would be determined under state law when all other "termination" questions are to be determined under Section 708. See *Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932) ("[s]tate law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law."). In this respect, Section 708 specifically provides that it applies for the "purposes of this subchapter" (subchapter K encompassing Sections 701 through 761 of the Code) without exception.

At all events, the decision below is entirely consistent with California law. While all of the community property of Ernest and Carolyn (including their partnership interests) was subject to probate administration on decedent's death in accordance with California probate law then in effect,[3] it does not follow that the partnership was instantaneously terminated and all of its assets were thereupon distributed to decedent's estate. Indeed, to the contrary, it is clear that Carolyn's one-half of the community property, including

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[3]During the period in question, Cal. Civ. Code § 5125 (West 1970) provided that the husband controlled the community personal property. In this respect, Cal. Prob. Code § 202 (West 1956), further provided that "Community property passing from the control of the husband * * * by reason of his death * * * is subject to debts and to administration and disposal under the provisions of Division III [Administration of Estates of Decedents] of this Code * * *."

her partnership interest, continued to belong to her individually and did not become part of decedent's estate. Cal. Prob. Code § 201 (West 1956). See *Bishop* v. *Commissioner*, 152 F.2d 389, 391 (9th Cir. 1945). Similarly, the fact that Carolyn managed the farming business as executrix of decedent's estate did not preclude her from acting, at the same time, on behalf of the surviving partnership. See *Keyes* v. *Hurlbert*, 43 Cal. App. 2d 497, 502, 111 P.2d 447, 450-451 (1941) ("When the surviving partner is also the personal representative of deceased, he acts in a dual capacity * * *."). In short, the authority vested in Carolyn as executrix did not limit her "rights and duties" as a surviving partner under California law. See Cal. Corp. Code § 15045 (West 1977).[4]

Finally, petitioners' contention (Pet. 9-11) that the decision below would require any husband-wife operated business in a community property state to be treated as a partnership is plainly wrong. The holding here, as the court of appeals noted (Pet. App. A-6), is limited to the case "where

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[4]Contrary to petitioners' contentions (Pet. 8), neither the "termination" provision of the partnership agreement nor the order of the probate court stating that the partnership had terminated upon Ernest's death is of controlling significance here. While the partnership agreement stated that the partnership would terminate upon decedent's death, it also provided for his estate to elect under Section 754 whether the basis of the partnership property should be adjusted, thereby indicating that the partnership would continue for at least some purposes and for at least some time after decedent's death.

Moreover, as the Tax Court noted (Pet. App. A-27), the probate court's determination made in a nonadversarial context during the course of administering Ernest's estate was not intended to resolve (and indeed could not resolve) whether the partnership had terminated and whether the bases of its assets could be adjusted for federal tax purposes. See *Michigan Trust Co.* v. *Kavanagh*, 284 F.2d 502, 506 (6th Cir. 1960). See also *Commissioner* v. *Estate of Bosch*, 387 U.S. 456 (1967).

a husband and wife executed a formal partnership agreement." Ernest and Carolyn executed such an agreement in order to vest Carolyn with the legal authority to manage their farming business, which was otherwise prohibited to her under the applicable community property law then in effect. See Cal. Civ. Code § 5125 (West 1970). The fact that the law was later changed so as to allow both spouses to have equal management rights in community property (Cal. Civ. Code § 5125 (West Cum. Supp. 1982)) does not, of course, have any bearing on the question presented here as to continued existence of the partnership at the time of decedent's death.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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